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of

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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BULLETIN
OF
THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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SOME PROBLEMS AFFECTING THE PROFESSION OF ACCOUNTANCY IN ENGLAND

By THOMAS KEENS, F. S. A. A., Past President of the Society of Incorporated Accountants and Auditors

THE principal concern of all members of the profession in every country is the present severe depression in trade and industry. Although Great Britain has suffered from unemployment for upwards of ten years, it is only during the last two years that the number of unemployed has reached the peak figure of two and a half millions. This figure, admittedly, includes a certain proportion of those for whom the provisions of the unemployment acts were never intended to apply; for instance, the woman worker who ceases to follow her employment voluntarily because of marriage, and the large number only partially employed, who, by arrangement with their employers, work only three days out of six and draw unemployment pay for the remainder of the week. When all necessary deductions have been made to arrive at a true index, the remainder is a figure that fills all thoughtful people with deep concern.

According to Mr. J. M. Keynes, that outspoken and competent economist, British industry may be able to stand the burden of a million unemployed, and with some difficulty two

millions: but the present number approaches the breaking point.

A revival of trade throughout the world alone can bring a real solution of the problem. Then a large number would be absorbed and employed in industry on an economic basis. The remainder could be dealt with by special schemes, for which various proposals have been made, and the problem would be of manageable proportions.

Obviously the depression in industry has affected the accountancy profession. The bodies of Chartered and Incorporated Accountants between them have 15,000 members and the number of entrants shows no sign of diminishing—rather the reverse. This is not remarkable. The process of rationalisation goes on, unitary production becomes larger and the possibilities of men becoming principals in business are becoming less. Therefore the professions become more attractive, since they offer opportunities for an independent livelihood, though not indeed comparable with the glittering prizes of wealth which industry and finance award to the favored few. The business of the accountancy profession bears a direct relation to the volume of trade and industry upon which our welfare depends. We are, therefore, much concerned for the future.

The present high rate of direct taxation in Great Britain shows no signs of diminution, although in the opinion of competent observers the limit of taxable capacity has already been reached. It is poor consolation to the long-suffering taxpayer that direct taxation has brought some grist to the mill of the accountancy profession.

The slump in the stock market of New York was followed with the greatest attention in London, and its repercussions have not been confined to America. Prior to the autumn of 1929 there was an orgy of speculation on the London Stock Exchange, though perhaps less intense than in New York. In England there was a reason for this, which I think was not operating in America. Profits or losses on stock exchange transactions in England are regarded as capital gains or losses:

the gains are not subject to income tax and the losses are not allowed. The taxpayer therefore, having desired some additional income not subject to tax, (and of course, he or she always expected to avoid losses) found the temptation to speculation with such a high rate of tax tremendous. Opportunities for speculation were bound to be offered, and the story of the gap between promise and performance makes sorry reading.

Mr. Henry Morgan, my successor in the office of President of the Society of Incorporated Accountants and Auditors, in his address at the Conference of the Society last year, produced some startling figures which made a profound impression upon the City of London and the Country.

He said:

Disastrous Flotations in 1928

An examination of the records of the new companies formed during the recent boom is very illuminating. Indeed, I must confess that when commencing my investigation to arrive at the figures which I am about to give, I did not anticipate that they would so completely illustrate the enormous extent to which the investing public has been exploited during the last few years. Taking the last six months of the year 1928, I find that the prospectuses of 58 companies formed for the purpose of establishing new businesses or developing new inventions or processes, were advertised in *The Times*. Their issued capital amounted to £15,117,000 and the estimated profits of 52 of the companies totalled £5,219,000. The prospectuses of the remaining six predicted substantial profits, but modestly refrained from stating any amounts. According to the latest information I have been able to obtain concerning these 52 companies, 16 have not yet published their first accounts and 14 of these are in liquidation. Of the remaining 36 companies only 5 earned profits which totalled less than £48,000 as compared with the prospectus estimates of over £214,000. The remaining 31 companies whose accounts are available suffered losses aggregating £690,000 as compared with prospectus profits estimated at £3,178,000. Of the whole 58 companies only one has paid a dividend, and 27 are already in liquidation, 14 under compulsory orders, in which connection the scathing comments of the Official Receiver are not without interest. Further, it would appear that at least 16 of the remaining com-

panies are in serious difficulties owing to losses from divers causes and, in nine cases, from the defaults of underwriters.

It is difficult to arrive at any definite estimate of the present value of the shares of these 58 companies. There is little likelihood of more than nominal amounts being returned to the shareholders of those companies in liquidation, whilst the shares of such remaining companies as are no longer quoted on the Stock Exchange are of negligible value. The value of the shares of companies still quoted is less than £750,000 at the present market valuation, which in many cases is purely nominal. On this basis it would appear that some 95 per cent. of the capital of these 58 companies has been lost, although this does not represent the total loss since the shares in many of the companies were purchased by the public at substantial premiums.

Circumstances such as these—and doubtless they have their counterpart in other countries—have contributed to the present condition of affairs, producing almost abyssmal pessimism. It is therefore not too much to say that the bulk of sound securities, particularly industrials, are now considerably under-valued.

The state of things to which I have referred raises again the important question of the proper control by shareholders over their own property. Under English Company Law, the auditor is appointed by the directors in the first instance but must be elected by the shareholders thereafter, his function being to make a report on the balance sheet to the shareholders annually. The directors again are subject to election by the shareholders and can be replaced as and when the shareholders desire. There is considerable discussion in England as to whether by these means the control exercised by the body of shareholders is really effective.

Mr. Morgan also answered this question on the platform and in the public press, on the following lines. Voting at annual general meetings is in the first case by show of hands, when every person present has one vote. The Articles generally provide that the declaration of the chairman that a particular resolution is carried or carried by the requisite majority

or lost is final and conclusive. The minority has a right to demand a poll. Before the meeting, however, the directors usually send out a form of proxy. This proxy appoints each of three or more of the directors as alternatives, to vote for and in the name of the shareholder. In any large company the proportion of shareholders attending is necessarily small and the proportion giving proxies in favour of the directors is usually large. On a poll being demanded the proxies are put in and independent shareholders are usually defeated.

How is this to be rectified? Mr. Morgan suggests that the practice should be made analogous to that of bankruptcy. In bankruptcy proceedings the creditor can give a general or a special proxy. If a general proxy is given, it can be used by the holder to vote upon any resolution submitted; if the proxy be a special one, the holder appointed can only vote in the way specified. Thus the proxy given by a shareholder would indicate whether his vote was to be given for or against any particular resolution, and each shareholder's vote would thereby become effective.

Whatever the merits of this proposal—and there are many—the prospects of any amendment of the Companies Act are somewhat remote. The Act only came into force on November 1st, 1929, and no president of the Board of Trade and no Government could find the necessary time at present for a new bill in Parliament. A further period of time is necessary to gain experience of the working of the Act and to decide whether any further amendments are necessary.

It has always been customary in matters of this description for the Government of the day to appoint a committee, on which the accountancy profession is represented, and to introduce a bill in accordance with the committee's recommendations.

Some measure of independence is secured to auditors by the provision in the present Act that no person, other than the retiring auditor, shall be nominated unless fourteen days before the meeting notice to move the appointment of some

other person shall have been given in writing by a shareholder. The notices of the meeting are usually sent out seven days before the meeting, and therefore the shareholders do have notice of an attempt to supersede the auditor. Theoretically this offers some protection for him, but in practice very little. In any case, it does not remedy the situation created by the present system of proxies, as the directors may desire to get rid of an inconvenient auditor, and if provided by the shareholders with the necessary proxies, they would not hesitate to use them on the resolution for the appointment of auditors. This question only arises infrequently, but it appears to me to be a question that must sooner or later occupy the attention of Parliament. When Parliament does deal with the matter, as on all previous occasions, the question will be considered from the point of view of protection for the investing public and the community, and not from that of the advantage or otherwise of the accountancy profession.

THE NEW BANKRUPTCY RULES IN THE SOUTHERN DISTRICT OF NEW YORK

By KENNETH MCEWEN, Counsel to The New York State Society of Certified Public Accountants

ON July 1, 1931, revised bankruptcy rules became effective in the United States District Court for the Southern District of New York. Their aim is speed and economy in procedure. Many desirable substantive reforms must await the revision of the Bankruptcy Act itself, which can be changed only by the Federal Congress. A full review of the history, plan and scope of the revised rules would involve a discussion of the Bankruptcy Act, the General Orders of the Supreme Court of the United States, the General Rules of the Southern District and other matters. There is no room here for such a symposium.

That the revised rules will accelerate procedure in most bankruptcy cases is altogether likely. To illustrate: attorneys for petitioning creditors are required to deliver the subpoena and a copy of the petition to the Marshall, for service upon the alleged bankrupt, within two days after filing an involuntary petition, and to commence publication immediately upon ten days' failure by the Marshall to secure personal service upon the alleged bankrupt. Disregard of this rule by attorneys may deprive them of compensation and subject them to citation before the Court by the Clerk. Further to induce the immediate delivery of the subpoena for service when the petition is filed the rules provide that applications for the appointment of a Receiver are not to be submitted until either the subpoena has been delivered to the Marshall or formal notice of appearance has been filed with the Clerk of the Court on behalf of the alleged bankrupt.

The Irving Trust Company is continued as the standing Receiver in Manhattan, Bronx, Yonkers, White Plains, Mt. Vernon and New Rochelle cases; hence, when the appointment of a Receiver is indicated in such cases, there can be no

delay attributable to selection. Upon a voluntary petition, the Referee may appoint the Receiver if application for such appointment be not made within twenty-four hours, if necessary to preserve the estate.

Parties opposing compositions are required to file affidavits of good faith; composition disputes are to be heard summarily, and ordinarily no withdrawal of opposition to a composition is to be permitted except on the affidavit of the bankrupt and his attorney that no compensation has been promised or given therefor. Similar safeguards are thrown around applications for the discharge of bankrupts.

Divers stipulations extending time are to be void unless approved by Court order. The time to answer to an involuntary petition may be extended only by Court order for adequate cause and conditions may be imposed upon granting such an order. "The Clerk shall enter the adjudication at the earliest possible date." These illustrations suffice to show the insistence of the Judges upon speed as an element in the adminstration of the Bankrutpcy Act.

Accountings by Referees, Receivers, Trustees, and Auctioneers will be more timely, numerous and frequent under the new rules than heretofore. The rules practically standardize the respective forms of such accountings. While the forms seem simple, yet one of the results of these requirements is likely to be improved accounting practices in many an office which has been haphazard in accountings. Good systems now in use will require little or no revision to meet the new rules. On the whole they will produce more and better accounting, with resultant economies in the long run.

Some of the critics of the present Bankruptcy Act have expressed the opinion that there will be no thorough reform until bankruptcy adminstration becomes a governmental function primarily. The present Act contemplates essential activities by the creditors which such critics say is either lacking or perverted in many cases, and that this is the

underlying cause of the scandals and wide spread dissatisfaction which came to light two years or so ago. Doubtless they will see a trend towards that governmental operation which they deem desirable in the continued designation of a standing Receiver and an official auctioneer, and more especially in the requirement that the Referees shall mail to each creditor "a form of proof of claim and proxy naming the Referee as special proxy to vote the claim in favor of the election of the standing Receiver as Trustee. By notice indorsed on or mailed with such form the Referee shall advise the creditors regarding the availability of such standing Receiver generally to act as Trustee, and how the proof of claim may be filed, with or without the proxy. The notice shall state that the creditor is not required to vote for such standing Receiver as Trustee." This seems to be only a few steps removed from the system which many authorities have advocated, whereby the adminstration of all bankrupt estates would be vested in a standing department or agency of the government.

Members of the Society should familiarize themselves with Bankruptcy Rule 16, relating in part to applications for allowances of compensation to accountants for services in bankruptcy cases. Obviously the matter is one of importance in itself. In fact it is doubly important, because Equity Rule 14 of the same Court, effective the same date, provides in effect that allowances to accountants employed by a Receiver in equity shall be as nearly as practicable upon the scale prevailing for similar services in bankruptcy causes. Unless fair compensation be obtained ordinarily in bankruptcy cases, it will be the exception in equity cases.

It is to be hoped that good fortune will attend Bankruptcy Rule 13; "Auditors may be appointed in appropriate cases as provided in the General Rules." It bears a simple aspect, but there is an interesting history behind it, and its future may hold possibilities of great usefulness to the certified public accountant.

General Rule 26, of the same Court, to which Bankruptcy Rule 13 refers, is as follows:

> "AUDITORS. In any Bankruptcy proceeding where the issue of insolvency is to be tried and in causes at Common Law, where accounts are complex and intricate, or the documents and other evidence voluminous, or where extensive computations are to be made, the Court may appoint an auditor to define and simplify the issues, to take and report testimony, to audit and state accounts, to make computations, to make findings on conflicting evidence and to make and file a report in the office of the Clerk, which report shall not finally determine the issue but shall, unless excepted to within ten days after the service of notice of filing and rejected by the Court, be admitted at the trial before the jury as prima facie evidence of the evidentiary facts and of the conclusions of fact therein set forth."

This rule appears to be based upon the decision of the Supreme Court of the United States in Ex Parte Peterson, 253 U. S. 300. Judge A. N. Hand, then sitting in the United States District Court for the Southern District of New York, over Peterson's objection, had appointed an auditor in an action at law which had been brought by Peterson as Receiver of a coal company to recover an alleged balance claimed to be due from the defendant upon transactions in coal. Peterson sought a writ from the Supreme Court prohibiting Judge Hand and the auditor from proceeding in Peterson's law action on the ground that the appointment of an auditor therein was unconstitutional and unlawful. The Supreme Court denied Peterson's petition for such writ, three of the Justices dissenting.

It appeared from the record before the Supreme Court that the amount involved in Peterson's law action in the District Court was substantial, Peterson claiming over $21,000 and the defendant counterclaiming for about $10,000; that Peterson's account contained 209 items, and the defendant's cross account 402 items; that 30 cash items of credit appeared in the latter which did not appear in the former; that 123 different deliveries of different kinds of

coal at different prices on 91 different days during a period of 11 months were involved; and that there were conflicting claims for allowances, penalties, commissions, freight, discounts, and other disputes.

Going into the merits of the question, the Supreme Court ruled that the Federal District Courts, in the absence of any controlling Act of Congress, had inherent power to appoint auditors, in law and jury cases such as Peterson's, involving complicated accounts and cross accounts; that such power was not dependent upon the consent of the parties to such suits; and that the exercise of such power was not in conflict with the Seventh Amendment of the Constitution of the United States, which provides that "the right of trial by jury shall be preserved."

It was held that in cases such as Peterson's it cannot be deemed an undue obstruction of the right to a jury trial to require a preliminary hearing before an auditor, or an undue interference with the jury's function to use the auditor's report upon items in dispute as prima facie evidence of facts embodied therein. "The auditor is an officer of the court which appoints him. The proceedings before him are subject to its supervision and the report may be used only if, and so far as, acceptable to the court." It was observed that the power to appoint auditors had been exercised from their organization by the Federal Courts when sitting in equity; and that Mr. Chief Justice Marshall had defined auditors in such cases as "a term which designates agents or officers of the court, who examine and digest accounts for the decision of the court. They do not decree, but prepare materials on which a decree may be made."

In short the Supreme Court decided in the Peterson case that an admittedly existing power of the Federal Courts in equity cases might be exercised in the Federal Courts in jury cases in the sound discretion of the District Judge; and so upheld Judge Hand's order appointing an auditor except in a minor particular not now material.

General Rule 26, supra, is therefore a sort of codification, by the Federal Judges in the Southern District of New York, of the decision of the Supreme Court in a case arising from that District. Its inclusion in the General Rules, and the reference thereto in the Bankruptcy Rules, of that District, should tend to make its use more general than when it was deducible only from the elaborate opinion of the Supreme Court in the Peterson case.

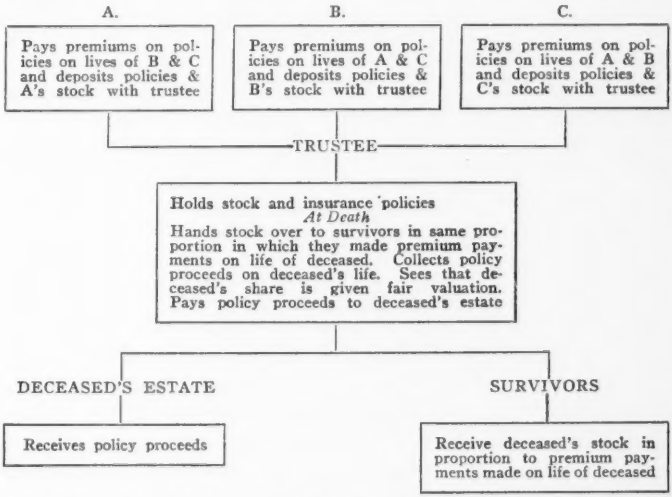
No doubt the Judges will ordinarily select lawyers as auditors in cases which necessarily involve taking and reporting testimony, the making of findings on conflicting evidence, the examination of legal documents, and similar functions which are a part of the regular routine work of the Bar. But the special skill of Certified Public Accountants may well be utilized by the Court, under these Rules, in cases involving contested issues as to insolvency, complex and intricate accounts and extensive computations.

BUSINESS LIFE INSURANCE TRUSTS

By C. Alison Scully, Vice-President,
Bank of Manhattan Trust Company

THE application of life insurance to the protection of business interests is one of the most recent and interesting developments in the business world. It is made effective through the business life insurance trust which is applicable to companies organized as close corporations, partnerships and proprietorships.

"A business life insurance trust consists of a program of life insurance whereby the proceeds of certain policies of insurance on the life or lives of one or more of the principals are payable to a bank or trust company as trustee, such proceeds to be collected and disbursed by the trustee in accordance with the terms of a written agreement between the parties concerned and the trustee." In the case of a close corporation it operates as is indicated in the following diagram:



N. B.—If the value of the deceased's share is more than the amount of policy proceeds available, the survivors make up the difference by paying the trustee either cash or notes. If the deceased's interest is less than the policy proceeds available, the trustee pays the surplus of cash to the survivors in the corporation in proportion to the amount of premiums they have paid.

Proper Valuation of the Interest to be Retired is Essential

There are several purposes which may be served by a business life insurance trust depending upon the circumstances of each case. However, *the value placed upon the interest which is to be retired is the all important element in the successful operation of the plan.*

It is self-evident that any value fixed in advance will not represent the true value at the time of the death of the owner unless the death occurs within a very short time after the value has been fixed. For example, in a partnership composed of four individuals, each owning an equal interest in a business with a net worth of $200,000 it is obvious that if a partner's interest in the business is today worth $50,000, six months from now it may be worth $60,000 or it may be worth $40,000, and even more violent fluctuations in value than these two extremes are not beyond the realms of possibility. Consequently, establishing in advance a value at which the interest of a partner in a firm or a stockholder in a close corporation is to be retired in event of his death works injustice either to the family of the decedent or to the surviving owners of the business. If, when the time for the interest to be liquidated arrives, the value of the interest in the business is less than that stipulated, the surviving principals in the business pay more for the interest of the decedent than that interest is worth. If more, the family of the decedent are the sufferers.

A few years ago there was in existence a company specializing in the manufacture of dried fish, glue, cod liver oil and other by-products of the fish industry and which had to its credit a very profitable record of earnings. Its officers were men of marked ability and excellent financial standing, this being particularly true of the principal stockholder who stood out a leader in his line of business.

In 1925 this man died and left his interest in the firm to his widow to carry on as best she might his part in the management of the business. His holdings equalled a small percentage over one half of the total amount of stock and it is not

difficult to picture the unhappy situation that arose soon after his death.

His widow who knew nothing about the business became automatically an important factor. Most unfortunately she was a very headstrong person and refused to listen to the ideas of the other men in the firm who knew the business thoroughly and who were thus hampered in every move or decision they attempted to make.

This internal strife continued for several years, the business went from bad to worse, and, added to these unfavorable conditions, there was a general decline in the salted fish industry. The situation became so bad that they were no longer able to pay dividends and the stockholders were forced to sell out to one of their important creditors. Of course, the other stockholders, who had suffered all along from mismanagement due to no fault of theirs, sold their holdings on a distinctly losing basis. In fact, at the date of the sale the book value of the stock was about $4 a share but the creditors were able to purchase it for about $1.06 a share.

It is easy to see that had there been insurance on the life of this principal stockholder for the purpose of retiring his interest at his death, this disaster which affected the lives of his widow and his business associates could have been avoided.

Methods of Valuation

There are several methods in vogue today prescribing how the valuation of the interest is to be determined when the death of the principal occurs and the insurance on his life is collected by the trustee. The various methods and the advantages and disadvantages pertaining to each are as follows:

1. Book Value

It is not uncommon that the agreement contains a provision to the effect that the interest of the decedent is to be liquidated at its book value. Such value is usually susceptible of ready ascertainment but there are two serious disadvantages: (1) the book value may be widely at variance from the

actual value, and (2) book value ordinarily makes no allowance for the good will of a business.

While there may be no deliberate dishonesty in fixing the value of assets for a business, a conservative policy of writing down assets may make the actual value of a business much greater than the books show. Conversely, income tax liability or a year of serious reverses may make the writing up of assets a useful expedient. A liquidation of an interest in the business after one or the other of these alternatives has been adopted is sure to be completed on a basis that is not entirely satisfactory to all concerned.

There is no more difficult element to value than the element of good will because the items to be considered vary with the line of business. The various formulae adopted for the calculation of the value of stock and other business interests for inheritance tax purposes are merely efforts to give tangible value to an intangible asset. Good will, if reflected in the balance sheet at all, is usually either grossly over-valued or given a nominal valuation of one dollar.

2. Current Valuation Agreed Upon by the Parties

A common provision in business life insurance trust agreements requires the partners or stockholders periodically to fix their own valuation on the business and to certify this valuation to the trustee. Usually it is required that this be done at intervals of every six months or year. While this method has been found to result satisfactorily in some cases it has certain practical disadvantages. Very often the principals tire of this periodical appraisal and neglect to certify the valuation to the trustee. As a consequence, when the death of one of the principals occurs the last valuation in the hands of the trustee may be out of date by several months or years.

In addition, it is not always easy to get the principals to agree upon the valuation to be placed upon a business. It is sometimes the occasion of difference of opinion and a source of controversy among them. If this results in no statement of net worth being filed by the principals with the trustee, or if

one or more of the principals should dissent from the valuation so arrived at, the result of the business life insurance trust is almost certain to produce dissatisfaction.

3. Arbitration

Another common provision is to the effect that upon the death of one of the principals the value of the proprietary interest of the decedent shall be fixed by arbitration. Usually there are to be three arbitrators, one representing the decedent, the second representing the survivors, and the third, supposedly impartial, to be selected by the first two. The objections to this method are that it makes a very cumbersome and prolonged procedure for determining the value. Two of the arbitrators regard themselves as representative of a particular interest and that they are protagonists. They do not approach the subject as impartial, disinterested appraisers. Furthermore, a valuation agreed upon by arbitrators may not be binding upon the parties concerned and if it is a source of dissatisfaction it may be subject to attack in the courts.

4. Valuation Fixed by the Trustee

While there are not many trust companies willing to make a direct finding as to the valuation of a partnership or close corporation interest, the most workable and satisfactory plan is to make the trustee the agency by which the valuation can be determined. This is best accomplished by the following formula: Require the trustee to have the books of the firm or corporation audited as of the date of the decedent's death. This audit will show the book value of the holdings and, using these figures as a basis, the trustee may be authorized to consult one or more additional persons to procure their judgment as to the actual value of the business interest. Usually these persons are engineers and those who are thoroughly familiar with the business in question, either as competitors or identified with an affiliated line of business.

Of course the book value is the starting point and in the ascertainment of the book value the services of reputable accountants are indispensable. When the trustee has sought and

obtained the judgment of other persons qualified to express an opinion as to the actual value of the business interest, the trustee should make its finding as to the value of the stock and such finding should be final and conclusive upon all parties.

A recent case has demonstrated the necessity of making some arrangement which will be binding upon the survivors in a business to purchase the interests of the decedent in the business at a fair price. Four brothers engaged in a business, each owning a 25% interest in a close corporation, had a written agreement among themselves, also incorporated in their wills, by which each of the brothers gave to the survivors an option to purchase his stock in the company at $50 a share. Two of the brothers died in quick succession. After the death of the first brother the survivors showed a ready disposition to acquire his stock and were reasonably fair in the terms which they made in its purchase, but by the time the death of the second brother had occurred the business depression had begun, the amount of ready cash in the possession of the two surviving brothers was limited, the tariff was having an adverse effect on their business, and they obstinately refused to pay any more than $30 a share for stock having a book value of $60 a share. When the option arrangement was entered into, it was assumed by all of the four that the $50 option price was in reality an act of grace to the survivors and that they would be eager to take up the stock at that figure. As it turned out, the estate of the second brother was done a grave injustice and a realization of value in any way commensurate with the real worth of the stock proved utterly impossible.

Innumerable cases of similar inequities in settling the estate of a deceased partner or stockholder in a close corporation will readily come to mind.

The business life insurance trust has made great strides during the last five years and while many have been created and are now in effect, there has not elapsed sufficient time to permit the actual liquidation of business interests in a large number of cases. As time passes and experience is had in the use of the different methods of valuation, a fuller knowledge

and a more mature judgment as to the fairest and most practical method of valuation will be obtained.

Usefulness

The need for the business life insurance trust is great and increasingly apparent. Prosperity and the bull market of 1928-9 demonstrated that every small or medium sized firm or corporation should have a plan which would furnish cash to liquidate the interest of a deceased partner or stockholder, if that should become necessary. In the case of the death of one of their number, the amount of money which the survivors were suddenly called on to furnish to retire the interest of the estate of their former associate in the business was prohibitive.

Business depression and the decline in security values of 1929-1930 have demonstrated the need even more emphatically. Today, if a partner in a firm or a stockholder in a close corporation dies without previous arrangement to retire his interest in the business having been made, the necessity of liquidating that interest may mean ruin. There are few businesses with an abundance of cash reserves. Certainly there are almost none with sufficient cash to pay off or out an important proprietary interest in the business. Sale and disposal of assets in the form of raw materials, stock in trade or real estate, sufficient to retire the interest of the deceased, could mean but one thing in many, many cases—the winding up of the business.

The need, in good times or bad, for some adequate plan by which the interest of a partner or stockholder may be retired in case of his death, without injury or interruption to the business, has produced the business life insurance trust. It combines the protection which life insurance affords with the thorough and impartial administrative effectiveness of the modern trust company.

SUPER-STANDARDIZATION

By HENRY M. BRUNDAGE, Vice-President
of the Consolidated Gas Company of New York

DURING the period from the founding of our Nation to the present day, it has been a most difficult task for our people to "be temperate in all things." The great American people, in many of their actions, oscillate like the pendulum of a clock, going from the extreme in one direction to the extreme in an opposite one. Every person who is old enough to remember clearly the World War recalls that during its trying period and for some years afterwards, *"efficiency"* was stressed beyond all reasonable bounds. It became a slogan for companies, industries and entire communities. When an individual found himself unable to secure a living through any of the usual avenues of human activity, he hung up a shingle and posed as an "Efficiency Expert." Fortunately for the Nation, the enthusiasm for "efficiency" has in large degree subsided, but another specter has arisen to take its place and haunt us.

As a people we now seem to be possessed with a mania for *"standardization."* Like many of its predecessors, it too is being sadly overdone. Attempts are being made to standardize every human activity, including not only the acts but even the thoughts of individuals. The craze has spread to such an extent as to justify the coining of the word which is the subject of this message, a word never before heard or seen on land or sea—"SUPER-STANDARDIZATION."

Looking at us from across the water, a humorous writer in one of the Paris papers recently said:

> "The Americans are obsessed by standardization and mass production. Their dream is doubtless to create a standard man and a standard woman, who, forming a standard couple, will produce standard children, as like each other as Mark Twain's famous twins. It is thus possible to imagine in a century all Americans will be as interchangeable as automobile parts."

The serious question is, shall we permit present trends toward standardization to reach the point where they prevent individual initiative, and thus allow ourselves to drift into the Old World tradition of doing all things just as our predecessors have done, or shall we allow each individual to effect improvements? By choosing the former we shall be killing the very thing that gave us tractors and gang plows instead of a wooden stick such as the people of Egypt still use in cultivating their fields.

Service has been standardized, as well as merchandise. There are banks, stockbrokers and insurance companies, having general offices in some metropolis with branches in numerous cities and smaller places. There are strangers in these branch offices who are not rooted in the community but who are hoping for promotion to branches in more important cities and therefore take little interest in local affairs. Education is standardized through institutes which maintain correspondence courses. There are organizations which select for their subscribers the books they ought to read. I do not know about the churches. Perhaps there is an organization for the exchange of sermons. If not, it is a possibility to be considered in the interest of standardization and the reduction of effort.

In the standardization of methods of big business, which has grown out of standardized production, and of government control of big business, which in turn, has developed from methods adopted by the business controlled, much has been gained in the direction of efficiency and economy and in lowered costs of production and distribution. Super-standardization has, in my judgment, grown to the point where its advantages are overbalanced by effects which are seriously injurious. A keen-witted foreign observer has said:

> "The new conception of production which is making America great is surreptitiously transforming the man himself and there lies its main and intense gravity."

Is that a true statement or is it merely a bit of rhetoric? Whichever it may be, the fact remains that the effect of this tendency is to paralyze personal initiative.

The local executive has, to some extent, lost his initiative and that power of prompt and wise decision which often seems intuitive, but which is really the result of long acquaintance with details of the business and the people connected with it, as well as the traditions and habits of those with whom the institution carries on its business.

This tendency was pointed out by former Judge William L. Ransom, in an address delivered recently before the Bar Association of Western New York. His conclusion was:

> "There is need for corporate structures and business systems which will preserve and restore individual opportunity, enterprise, initiative and responsibilty and develop to the utmost the traditional advantages of private ownership under vigorous individual leadership which emphasizes the welfare of the workers along with the utmost efficiency in the processes of the business."

The movement for consolidation of industries has its counterpart in the continued encroachment of the Federal Government on the sovereignty of the individual States and in the endless multiplications of bureaus at Washington. Bureaucratic adminstration congeals into inflexibility, as mass production becomes rigid, because a change in any one part makes it necessary to reorganize the entire factory. Bureaucratic adminstration operates through subordinates in distant communities who are, necessarily, unacquainted with local problems or out of sympathy with them. Its administrative officers and employees become the slaves of rules and regulations which kill initiative and standardize those who must observe them even more than do the rules and regulations of the chain stores. They become creatures of obedience, rather than creative agents.

Over the portals of the Temple of the Oracle at Delphi were engraved these words: "NOTHING TOO MUCH." It is impossible to condense more wisdom into three words.

They express a universal truth. They are for all times, all places, all peoples. They point to the golden mean between extremes—extremes to which man is ever prone to rush. If the Greeks themselves had only followed the injunction of their famous Oracle more faithfully, "the glory that was Greece" would have shone longer and even more brightly than it did. History proves that nations suffer more from their internal excesses than from their external enemies.

Let me make it clear that with standardization, *per se,* I have no quarrel. I believe in it, thoroughly. The economies it has made possible, the waste it has prevented, the efficiencies it has created are among the basic causes of our industrial leadership. Without standardization, mass production could not have been accomplished and American industry would have missed its most unique and outstanding achievement. All this is freely conceded. No one in his senses would condemn the kind of standardization which is exemplified by the American Standards Association, the United States Bureau of Standards, and other similar bodies, both public and private. Their actions are predicated upon a thorough study of the facts of each case, in which all essential parties in interest participate, and their joint contributions to industrial progress are so great that their value can not be measured in monetary terms.

But, as invariably happens, there are certain over-enthusiastic or misguided souls who are not content to await the slow, laborious processes of examination and fact-finding. Having tasted the fruit of the standardization tree and found it good, they would raid the orchard. Or, to change the metaphor, they proceed on the theory that if one teaspoonful of medicine is good for the patient, two teaspoonsful ought to be twice as good and the whole bottle proportionately better. If mass production of goods is beneficial, they argue, why not mass production of ideas? If you can profitably standardize the one, why not the other? If all people can be induced to think alike and take their opinions ready-made as they do

their breakfast cereal, it will not only greatly simplify the problems of mass production by making everybody want the same things but will render the organization of mass movements of various sorts—already too easy—still easier. To the type of mind that is looking for short cuts to Utopia, and is not too particular as to the means employed, this offers an opportunity too tempting to be resisted; and so we are deluged with slogans, catch-words and phrases, and other bromidic, stereotyped expressions, all artfully designed to appeal to the "herd" instinct and to sway the multitude in any given direction.

We live in standardized houses, sleep in standardized beds, wear standardized clothing, eat standardized food, read standardized books, and if we do not yet think standardized thoughts it is only because the old American brand of individualism, inherited from pioneer days, is hard to kill.

Not even newspapers have escaped the standardizing process. There are chains of newspapers, whose policies are determined, for each chain, in a central office. They print the same editorials simultaneously in each of the chain papers in many cities, the same syndicated articles on sports, literature, religion, crime, jokes, scandals and funny pictures, side by side with a local flavor of advertisements of such merchants as have survived the chain stores, and with a front-page smattering of local news. They dot the country like the chain stores and operate on much the same plan. When they come in, individualism and independence go out. One-third of the total daily newspaper circulation of this country to-day is controlled by chain ownership. The personal note has all but disappeared from American journalism. The old-time editor may soon be as extinct as the old-time cab-driver. Greeley, Dana, Bennett, Pulitzer and others of the tribe of journalistic giants have gone, leaving no successors. The business office has, I fear, displaced the editorial sanctum. The flaming zeal of the crusader has given way to the cool, calm calculation of the opportunist. The ideal of the chain newspaper is to be "all

things to all men," for thus is circulation boosted and advertising revenue increased.

Admitting that the trend toward newspaper consolidations has a sound economic basis and that many substantial advantages to both the public and the papers have resulted from it, one can not contemplate the passing of the independent newspaper—the newspaper with a personality—without a pang of regret, which is not lessened by the utterances of some of the spokesmen for the chain system. One of its outstanding exponents, referring to the extension of the chain newspaper to many rural communities, is quoted as saying: "This tremendous advance in the development of the small dailies of the country, which is a direct result of syndication and chain operation, has, *by a system of setting in action identical thought processes in all communities of the nation at almost identically the same time,* annihilated provincialism in the United States and contributed to the development of a true American hegemony that is the marvel of the rest of the world."

I confess my inability to share in this admiration for a system that sets in action "identical thought processes in all communities of the nation at almost identically the same time." To me, this is nothing short of calamitous. When all of us think the same thoughts at the same time, we shall have achieved the ultimate in mental sterility. If this is to be the result of mass production and standardization in the newspaper field, then the price paid for it is too high, whatever may be the benefits.

Whatever else we may wish to do in this direction, we certainly do not want to standardize the American mind. I doubt if even the most ardent super-standardizationists would openly avow that as one of their objectives. But they probably do not realize that when you standardize everything that man uses you have gone a long way toward standardizing man himself. Or, turning it the other way around, if there is an attempt, conscious or unconscious, to standardize the individual in order to standardize the things he uses, this, as an acute

observer of American life points out, "is to lose sight of the fact that goods were made for man and not man for goods."

There must, of course, be some compromise between standardization and individualism. We can not and should not have an unlimited degree of both. In their extreme forms they are mutually antagonistic. Unrestricted individualism means anarchy, with each individual a law unto himself, while complete standardization destroys the identity of the individual by making him a mere cog in a vast, impersonal machine. We do not want either of these extremes. It is well understood that wherever men unite for a common purpose the individual must surrender a certain freedom of action for the good of the group. In no other way can the benefits of cooperation be secured. On the other hand, it should be equally well understood that standardization must stop short of the breaking down of individualism. We need standardization and we need individualism. Neither must rule to the exclusion of the other. There is plenty of room for both. The problem of how to maintain a balance between the two which will preserve the salient advantages of each is assuredly not a simple one, but we shall be helped toward the solution if we remember St. Paul's admonition to "be temperate in all things" and take as our ideal the golden mean expressed in "Nothing too much."

The individual stands at the very apex of American institutions. To protect him in his "life, liberty and the pursuit of happiness" this government was founded. That the State exists for the individual, and not the individual for the State, is the keystone of Anglo-Saxon civilization.

The end and aim of government is to insure protection of and justice to the individual. This principle of individualism finds its highest expression in our constitution and fundamental laws. It is our heritage from the fathers. The great success we have attained in making this country the foremost in the world in all that relates to material well-being—all in the comparatively short space of 154 years of independent exist-

ence—is a triumph of individualism. In the words of John Temple Graves II, in a recent article in "Nation's Business:" "I am one of those who believe that this individualism, properly scaled and expressed, is the finest asset of an America threatened by its own mechanical and administrative genius with a disastrous standardization." We shall indeed be recreant to the traditions of the past and the vital interests of the present if we permit our priceless inheritance to be dissipated under any temptation whatever.

If we are all to be trained to think and act alike, in response to some levelling process, then our thinking and acting must conform to the lower and less intelligent types because these are by far the most numerous in any population. Whatever is intended to influence the mass mind must be reduced to the comprehension of the lowest mental stratum, or the masses will not be reached. Therefore, if thoughts and ideas are to become standardized in the fullest and widest sense, they must be those, and only those, which the least intelligent can understand. This would tend to reduce us all to a common level of intelligence and that the lowest. The rampant Communism of Russia is the ultimate result of super-standardization carried to its inevitable conclusion. To call such a standardization disastrous is to err on the side of mildness.

Few indeed cherish the delusion that they could be a Shakespeare, a Beethoven, a St. Gaudens, or a Bobby Jones. But the number of people who are convinced that they could run the business of the country and our great industrial enterprises better than they are being run is legion. Why this should be so must be set down as a paradox not easily explained, for the same laws of natural selection operate in the one case as in the other.

Real, outstanding leaders, in every field of human activity, are rare at any time and constitute the glory of the age in which they live. They are *not* developed by the standardization process. That is a process that seeks to level out all the differences and inequalities of human nature. Rather, they are

developed by a process of "natural selection" as opposed to "social control." Attempts at standardized or artificial control, however well intentioned, do not pull the bottom layers of humanity up; they merely push the top layers down.

Unless we are able to place a curb upon the tendencies of which we have been speaking, we must be prepared to face the penalty. What is the penalty, and is it something that can be formulated into law? I think it can. Not statutory law, which is often futile and ineffectual, but natural law, which is certain and inescapable. It is a law which the economists call "the Law of Diminishing Returns." Most of us are probably familiar, in a general way, with this law. In its primary significance it refers to the cultivation of land, and means that, up to a certain point, increased applications of capital and labor to land will yield proportionately increased returns, but after this point is reached, additional applications of capital and labor will cease to yield proportionate returns. In other words, the added cost to produce constantly larger returns from a given acreage will at length become so great as to make the effort unprofitable.

That is the original and narrow statement of the law. But it has been discovered to be of infinitely wider application. It operates in practically every department of human activity. It is this little understood but inexorable factor which has the last word in so many of our undertakings. Mr. James Truslow Adams, in a thoughtful article in "Harper's" Magazine, entitled "Diminishing Returns in Modern Life," calls attention to some interesting aspects of the working of this law. Not so many years ago, he reminds us, taxicabs were comparatively rare in the streets of New York. For a while they were great time-savers, but they multiplied "like rabbits in Australia" until now the streets are so congested with them and other motor vehicles that, if you are in a hurry, you can often save time by walking rather than riding. The Law of Diminishing Returns is at work. The height of a building that can be erected on a given lot depends on a number of factors, but there is obviously a limit beyond which additional floors will

cease to yield commensurate returns. When our beaches become so crowded that the individual no longer has elbow room —a condition even now approached, if not reached in some cases—then no one will longer derive any pleasure or benefit from them. The Law of Diminishing Returns will have operated one hundred per cent. Examples to similar effect could be multiplied indefinitely.

Many a business has come to grief through ignorance or disregard of this law. Sooner or later, at some stage in every process of business expansion the limiting factor of diminishing returns is encountered. To recognize this and to work with, not against it, calls for the highest type of business statesmanship.

Even in the field of politics and government the law still holds. It was Plato—perhaps the wisest of the Greeks—who made the profound observation that every form of government tends to perish by an excess of its basic principle; that even democracy may be ruined by an excess of democracy. Up to a certain point the functions of government can be expanded with benefit to everybody, but if pushed beyond that point they overflow into socialism, and then good-bye to democracy. If the government should step over the boundary of its historic and legitimate functions and undertake to run the business of the country, now in the hands of its citizens, both government and business would be ruined in the process. Our respect for the intelligence of the ancient Greeks mounts higher and higher, the more we ponder the distilled wisdom of "Nothing too much." Would that it were blazoned in letters of fire over the entrance to every legislative chamber!

Coming back to our subject of standardization, how does the law work in this field? Standardization of tools, patterns, processes and products conducted on rational lines has been a boon to industry and is one of the pillars of our prosperity. We are proud of its achievements. It is a monument to the American genius for doing things in a big way as befits a

great people. This is acknowledged freely and without reserve. But there is a limit even to the standardization of goods. We cannot afford to dispense entirely with the artist and the craftsman. Though their sphere has been greatly curtailed in some respects, they still have something vital to contribute to human comfort and to the joy and beauty of living. Their work can not be put on a mass production basis. In a world where every material thing had been standardized there would be no room for them, yet any scheme of life that crowds them out will suffer an irreparable loss. That loss is a measure of the penalty exacted by the Law of Diminishing Returns. If to standardization of things we attempt to add standardization of ideas, the penalty is even more severe, for in the end we shall find ourselves destitute of any ideas worth having. "My mind to me a kingdom is," and that kingdom cannot be too jealously guarded against influences which would make it a mere stencil for the recording of super-imposed impressions.

The conclusions which I reach from these reflections may be stated briefly. Our experiment in democracy was based on the theory that, under such a form of government, the individual would have the fullest means of expression, consistent with national unity. Individualism was characteristically American until we began to reach the era of standardization. Through standardization and centralized management, opportunities for self expression have been curtailed, with the result that, in our economic and social life, we have become members of groups, rather than individuals and our capacity for self expression has been weakened. Craftsmen have all but disappeared. We conform to common standards of dress and deportment, under penalty of ridicule. When required to make decisions in business, we act on advice from our superiors, sometimes because of lack of confidence in our own judgment, but more often because it is compulsory to seek such advice, or to comply with rules and regulations which cover every conceivable situation. Standardization has made mass production possible which, in turn, has led to consolida-

tion of industries, where such consolidation is feasible. Industrial leadership has been concentrated into comparatively small groups. In the interests of efficiency and economy in management, and to oppose the influence of industrial and banking leaders, the Federal government exhibits a strong tendency to a like extension of its power, with the result that it constantly encroaches on State sovereignty. Extension of Federal power is followed by an increase of standardization, in the form of rules, regulations, decisions and orders emanating from Washington. The motives underlying such extensions are the desire of political parties to secure control of Federal offices, including Congress, through elections and, to this end, campaigns are conducted on wholly baseless assertions that banking and industrial leaders scheme to control the government. A present instance is the use of the term "Power Trust." A number of members of Congress curry favor with the electorate by the introduction of laws authorizing the Federal government to invade fields hitherto reserved for private initiative. This tendency is in the direction of socialism. One of the planks of the Socialist party, and its ultimate goal, is government ownership and operation of all instrumentalities of production. Some spokesmen of the two great political parties, who obtain their ideas from socialistic writers, without giving them credit, are demanding government, state and municipal ownership of public utilities. Socialism is the antithesis of individualism, which latter is the basis of our form of government. In proportion as it advances, local color disappears and life becomes a drab monotony of existence.

The solution of the problem rests with the American people, but as a preliminary to such solution they must be awakened to the facts and conditions confronting them.

CO-OPERATION WITH BANKERS

Semi-annual Report of the Committee of The Robert Morris Associates

[The June, 1931, report of the Committee of The Robert Morris Associates on Co-operation with Public Accountants, by courtesy of the Chairman of the Committee, Mr. H. E. Whitney, is reproduced here for the information and guidance of the members of The New York State Society of Certified Public Accountants.]

AT THE Briarcliff meeting last October, while an entire morning session was given over to a discussion of accountancy problems, at which were present representatives of the committees of the American Institute of Accountants and The New York State Society of Certified Public Accountants, we were unable through lack of time to cover all the questions submitted and the balance were disposed of at a subsequent meeting conducted under the auspices of the New York Chapter. The proceedings of the two meetings have been printed in pamphlet form and distributed to our members. Furthermore, several hundred copies were requisitioned by different accounting firms for distribution throughout their organizations and to clients. This pamphlet makes most interesting and instructive reading and should be a permanent addition to the Credit Department library of every one of our members, thus being available to the juniors for educational purposes.

Certificates

It is a rarity when the report of our committee does not lay emphasis on this important topic and the following examples are submitted as of interest.

(a) In our report made to the Cleveland meeting in October, 1928, we called attention to the wording of a certificate on the statement of a commercial paper name, as follows:

> "We hereby certify that subject to the comments attached to our complete report of above date, the balance sheet herewith is a true statement of the financial statement of the company on December 31, 1927, to the best of our knowledge and belief."

One of the members of our committee, being curious to know what the comments were, called for the complete report, ascertaining that the books of the company were kept open for a week or ten days after the turn of the year in order to get credit for certain receipts and payments, Liberty Bonds, while only a small item, were hypothecated and the merchandise account had not been verified as to quantities nor values. At that time the commercial paper broker advised that the request from the member of our committee to see the detailed audit was the first he had ever received. Statements as late as December 31, 1930, bear a similar certificate and it is our understanding that there are still many buyers of the note who do not ask for a copy of the comments referred to in the certificate nor for any information regarding them.

(b) Financial statement of a corporation whose note is offered on the open market bore the following certificate:

> "In accordance with your instructions, we have made a limited examination of the foregoing financial records of your company for the year ended December 31, 1930. We counted the cash on hand and verified the cash in banks by certificate from the depositories. We compared the accounts receivable ledgers at the home office with the controlling account.
>
> "We submit herewith a statement of financial condition at December 31, 1930, as reflected on the general ledger of the company and subject to the qualifications that we made no verification of the supporting and subsidiary records except as specifically mentioned above."

One of our members who reads certificates carefully determined that this was nothing more than a rephrasing of the certificate we see from time to time to the effect that the statement is correct "as shown by the books." As the statement of the previous year bore what appeared to be an unqualified certificate and as the statement of 1930 showed no liabilities whatever except a reserve for income taxes, he made some inquiries obtaining an explanation that as the 1929 detailed audit had not developed any particularly useful information the company itself had authorized the accountant for

1930 to do the more or less superficial job he had been doing in previous years. As to the absence of liabilities, the explanation was that the company actually kept its books open for a short time after the end of the year in order to pay up everything bearing date of 1930. The latter is of course a practice very properly frowned on by the banks and in good accounting circles, and there is no excuse for an accountant's not referring to this circumstance in his certificate even though it is qualified to the extent indicated above.

(c) A note appearing in the commercial paper market was supported by a statement of December 31, 1930, upon which appeared a certificate that in the opinion of the accountant the financial position was correct "accepting the book valuations of the tangible and intangible property accounts." Apparently some banks were willing to buy the paper and banks who had the account were willing to loan the company direct without further inquiry, and yet here is a phrase that broadly interpreted would just about cover every asset item that might be in a statement. This was put up to the accountant from two different quarters. One advised us that the accountant construed tangible property to mean real estate, machinery and inventory, while from the other quarter we heard his explanation was that this included real estate, machinery and fixtures. In both cases he said that the intangible property accounts referred to an investment item of exactly $1,000.

Later one of the banks of account wrote us that they had discussed this situation with their customer and had brought him to a realization of the fact that he should have allowed the accountants more leeway and thus enabled them to append a satisfactory certificate. While we are not informed as to this point it would not surprise us should we learn that the unsatisfactory job, rather than being the fault of the accountant, was brought about by negotiations on the part of the principal as to the amount he was willing to pay. When any concern allows this to become the major consideration in

connection with an audit, they may not realize it, but the fact of the matter is they actually defeat their own ends. This fits in with an experience of your chairman. An audit that came to his attention struck him as most informal and upon questioning the principal it was ascertained he paid $600 for the job. The answer to him was that he apparently got just what he paid for which was approximately nothing at all, because no reputable accounting firm could do a worth while job on a fairly sizable concern at this price or anything like it.

(d) A complaint was filed with us respecting a firm of accountants who were supposed, in connection with their preparation of a financial statement, to have missed a substantial amount of accounts payable. While all of this may be quite true, your chairman had an opportunity of looking at the financial statement in question with the comments made by the accountant and it was another case where a bank had accepted as an audited statement what on its face was a very incomplete job and which, incidentally, bore no certificate whatever. A careful reading of the letter of comments should have been a warning to the bank rather than serving, as it apparently did, as a basis for confidence in the risk.

(e) In another case a member brought up for attention a printed financial statement which was properly certified, whereas the operating account on the following page of the report bore no certificate. This is not entirely unusual and what happened was that the company asked the accountant to certify the financial statement and ignore the operating account which is just what was done. If a bank takes exception to this it is a matter between the bank and the client and does not involve the accountant.

(f) In the financial report of one of the important industrial corporations of the United States having accounts in many of the large banks, the accountants in the opening paragraph of their certificate accompanying the statement, refer to the fact that they submit a consolidated balance sheet together with condensed summary of income and expenses and surplus

account. Then follow several comments and in the concluding paragraph they certify merely to the balance sheet. The accountants stated that it was not their purpose to certify to the income account and under such circumstances we consider the opening paragraph misleading, as unquestionably the banks of account believe they are getting a certificate that applies to the operating account as well as to the statement itself.

The two examples cited immediately above raise a question that would be an informative subject for discussion at a meeting with the accountants, namely, under what conditions might an accountant be willing to certify to a balance sheet and yet decline to certify to the operating account?

(g) We noticed a reference in the public press to the difficulties of a foreign corporation, the accountants being blamed for lending their name to a misleading report in previous years, the situation being brought to a head by the fact that in the 1929 report the accountants qualified their certificate by stating that it was "subject to values under present conditions of investments in allied companies." This brings up another interesting subject for discussion, namely, as to how far an accountant is at liberty to go in certifying to a statement even though it is qualified, when he has reason to believe that the character of the qualification is of such a nature that it materially affects the financial showing unfavorably.

And while we are discussing controversial phraseology and the like, what significance should be attached to a certificate such as came to our attention recently which affirmed the correctness of the statement "as a going business at the date stated"?

Miscellaneous Faults

As indicating the fact that the credit analyst should be of an inquisitive turn of mind, we will cite briefly the following examples that have been submitted to us recently:

(a) Financial statement of December 31, 1929, included an item in current assets "Notes Receivable—$25,400." This rep-

resented miscellaneous loans and advances which were not of a current nature.

(b) Financial statement August 31, 1930, included in current assets an item "Notes Receivable secured—$528,000" which should not be classified as current because it represented loans made to individuals primarily for investment purposes.

(c) A condensed balance sheet prepared for distribution to banks of account and the commercial paper broker, neglected to refer to a contingent liability for bills receivable rediscounted, which liability did appear in the detailed audit.

(d) Audited statement of September 30, 1930, submitted to banks of account contained a number of qualifications. A condensed balance sheet prepared for the commercial paper broker was certified to without qualifications.

While on this matter of condensed balance sheets regarding which we have sounded a warning from time to time, you will be interested in the following excerpt from a letter of instructions sent out by one of the large accounting firms to its branch offices:

> "*Condensed balance sheets:* Please note carefully this heading and the use of the word 'Condensed.' I think all of our executives appreciate the extreme danger in issuing this class of statement because it is so frequently used with banks and note-brokers for borrowing money. It, therefore, is a direct responsibility of our Managers, wherever this form of statement is issued with our certificate, to *carry a footnote thereon* that these figures are taken from our complete audit report. The value of this lies in the fact that our complete audit report carries details and comments regarding various qualifications in our audit which are not referred to in the Condensed Balance Sheet. Notebrokers make copies of our statement and distribute them widely to banks.
>
> "The other information contained in our detailed audit reports is likewise valuable to a bank because their credit departments have further information for their own private checking of the account. There can be no honest question raised about our placing the *footnote* I have stated herein on the bottom of

the Condensed Balance Sheet, because it serves a very valuable purpose as a protection to our firm."

General Comment

Good accounting practice, as reflected in recommendations embraced in the pamphlet, Verification of Financial Statements, requires that where a company invests for one reason or another in its own stock or bonds, such securities should be specifically captioned in the financial statement and not included without comment in an item of "Investments." Having this distinctly in mind, our attention was arrested by a sentence in a certificate that accompanied a December 31, 1930, balance sheet reading as follows:

> "Investments are carried at cost and include shares of the company's own stock which have been purchased for corporate purposes."

The balance sheet item, including this stock, was labelled "Investments." While the handling of this matter does not technically meet the requirements just referred to, it is your chairman's feeling that the accountant has protected himself from any criticism as he spells out the situation very clearly in the certificate and by this time we should have learned that the certificate is a very important element in considering the figures themselves. The interesting thing about this is that upon investigation we ascertained that the accountants had recommended handling this matter in the approved fashion, but this was violently objected to by one of the directors of the company who, incidentally, is a vice president of a prominent bank, one of whose officers was a charter member of the Robert Morris Associates. This instance emphasizes one of the embarrassments that occasionally confronts an accountant, to the effect that the preachments of the Robert Morris Associates have not percolated through some of our own institutions. This of course is not to be wondered at but does raise the question as to whether all of us have been as active as we should be in broadcasting our doctrines. As this particular accountant expressed himself, he wished that all his bank con-

tacts might be with Robert Morris members as many embarrassing situations, of which the one just described is a fair example, would not arise.

One concrete example that this is so is indicated by the following circumstance. Such of our members as take a sufficient interest in the work of the committee to read the articles that appear from time to time in our *Bulletin*, may recall one that was in an early issue this year under the caption "Next Season's Merchandise." This referred to the practice more or less prevalent of omitting from both sides of a statement merchandise on hand but unpaid for and its equivalent liability and showing this as a contingent item. Reasons were given why it was regarded that this practice was unsound and we recommended that accountants and banks co-operate in endeavoring to convince their clients that there was only one right way of handling such matters and that was to show them on both sides of the statement.

As evidence of the fact that the seed so sown has borne some fruit, an instance came to our attention where the customer of a certain bank brought in his financial statement and explained to a loaning officer that ordinarily it would show a better ratio but the accountants had insisted that he include a merchandise item of about $160,000 and in the liabilities an accounts payable item for an equivalent amount. He said he put up quite an argument with the accountant but the latter was insistent that it be done that way, stating that when he presented his statement to his banks and explained the situation they would compliment him rather than criticise him because the ratio was no better.

This is exactly what did happen, but maybe it is fortunate that the loaning officer happened to be an active member of the Robert Morris Associates.

Before leaving the subject of the specific captioning of a company's holdings of its own stock, we should mention one instance where a financial statement of December 31, 1929,

embraced an item in current assets of "Marketable Securities" of approximately $25,000. With the exception of about $2,000, this was made up of the company's own stock which the accountant admitted should have been specifically captioned. Your chairman would like to say, however, for the general information of the membership, that he has discussed this practice with many accountants and while they recognize the propriety of segregating such an item, more than one of them stated that if the client specifically took exception to such segregation and, in the opinion of the accountant the item was immaterial, he would probably accede to his client's wishes.

In his opinion, rendered in connection with the suit for an injunction against the proposed Bethlehem-Youngstown merger, the judge digressed from his analysis of the case to comment on the desirability of uniformity in accounting practices. This makes sufficiently interesting reading to justify incorporating in this report the following extract:

> "Action should be taken by cognate industries voluntarily and not by legislative compulsion, with the cooperation of the accounting profession to make uniform, as far as possible, their accounting processes, for purposes of setting up uniform standards of comparison of accounts, earnings and values for the guidance and necessary knowledge of directors and shareholders, as well as of the investors generally.
>
> "I am further of the opinion that directors, shareholders and incidentally the courts, should have a clear, explicit explanation of the accounting facts relating to a corporation in form and language, which in accordance with common sense will enable the ordinary reader, without hiring a technical interpreter, to determine the actual state of the company's business, prospects and value. Corporate statements and reports are for the information of the layman, not of skilled accountants. Such a purpose being so fulfilled, a repetition of the months spent in this case, with the use of language and schedules that not even skilled executives in the corporations involved could understand, would be done away with."

One of our good friends in the accounting profession has asked the Robert Morris Associates to insist that their clients

submit to having accounts receivable verified; if not 100%, at least the accountant should be allowed to make a selection of a sufficient number of accounts for verification as would justify him in feeling that in substance the receivables were good and collectible at their face value. Today this is the exception rather than the rule and more than one instance has come to our attention that would indicate that this is a proper request and should have our full co-operation.

Examples other than those referred to in this report have come to our attention, of very poor work done by certain accounting firms. It has never been our practice to use names, which at times we almost regret, as in these instances the audits were of a most inferior character.

Respectfully submitted,

JOHN CLAYTON
J. N. EATON
P. F. GRAY
G. A. VAN SMITH
H. S. WASS
H. E. WHITNEY, *Chairman.*

It is now nearly ten years since the organization of the Committee on Co-operation with Public Accountants, and conditions have necessitated my asking to be relieved of the chairmanship. I have really enjoyed and I know personally profited—not financially—by my activities, and whatever has been accomplished may be attributed in a large way to the support I have received from so many members of our organization. The one thing that has surprised me is the apparent lack of interest to ascertain the names of the principals involved in the many specific circumstances outlined in our semi-annual reports.

One of the most constructive and far-reaching results of our work is the organization of similar committees by the

various chapters. This was a suggestion of our secertary, Mr. Alexander Wall, and it means that the work will go on in a more intensive way through many additional members being brought into active contact with it. We have tried to make it a committee of co-operation, not of criticism and we have met with a hearty response from the accounting profession at large.

In conclusion I should like to summarize my reactions in this way. We should not be too technical in our attitude toward accountants. I know that they recognize their duty to the credit granting fraternity as well as to their clients, always reserving to themselves the right to construe what they regard as material or immaterial in the make-up of a financial statement. It is, of course, for us to criticise and if necessary condemn, when, in this connection it can be satisfactorily established that the judgment of any particular accountant has been unsound. The accountant, as well as the banker, entitled to confidence, is the one who observes not only the letter but as well the spirit of the laws and the ethics governing his profession. Summed up this is "Good Faith."

HARVEY E. WHITNEY.